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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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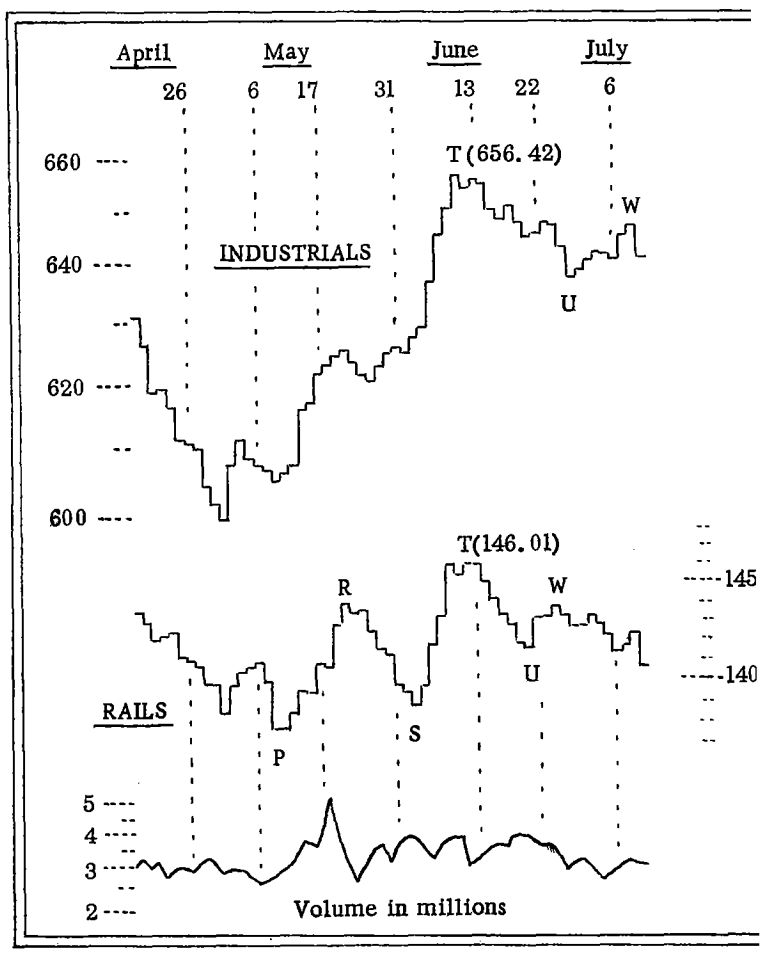
PRICE MOVEMENTS. In discussions of the price movements I try to place perhaps 70% emphasis on the primary trend, 25% on the secondary trend and 5% on the minor trend. The single most important fact for any investor to know is the direction of the great primary trend (tide) of the market. A bull tide eventually will affect everyone's business and pocketbook favorably; a bear tide will cause a good many hardships and unpleasantries before it has run its course. Dow's Theory was designed to aid businessmen and investors by providing them with advanced knowledge of forthcoming periods of prosperity as well as early warning signals when the tide of prosperity has turned down.

When small zig-zags composed of a few days' to a week's price action appear in both Averages, the significance applies to the minor trend. When two or more successive zig-zags appear in both Averages, the significance is usually of secondary importance. When, under certain conditions, a major zig-zag is formed by both Averages (consisting of a secondary movement, a full correction of that movement and then a re-penetration of the secondary points) the structure may have primary significance. Just as the daily (minor) movements often forecast secondary action, so secondary movements can warn us of a continuation or a reversal of the primary trend.

In the last Letter I wrote that in a bear market values erode with the passage of time. I added that the longer the Rails resist confirming above the 146.56 level, the less the odds favored such a move. Price movements during last week and early this week provided the first indications of Rail weakness since point P (see chart). From their mid-June high at T (146.01) Rails declined to U, then rallied to W. Following the minor peak at W, a series of two descending zig-zags took Rails under their preceding low at U. Thus the recent bullish Rail structure P-R-S-T (see Letter 109) showed signals of crumbling.



Over the same period the Industrial Average gave a somewhat better account of itself. Having retreated in a series of minor zig-zags from T (656.42) to U (637.46), the senior Average firmed and stubbornly refused to confirm the Rail weakness. In fact while the carriers were sinking lower Industrials actually rallied to form an upward zig-zag (U to W).

Then on the sell-off of Monday (June 11) prices dropped abruptly; in a single day Industrials lost half their gains since U

while Rails closed at their lowest point in a month. Volume indications (so far) have not been helpful, and the market has shown a tendency to grow dull on both rallies and declin

CONCLUSION. The primary trend of stocks is down. A Rail bettering of 146.56 (preferably with Industrials advancing "in gear") would signify that the secondary trend is up. A Rail penetration first of S (138.87), then of P (137.68) with Industrials confirming through U (637.46) would be bearish and would suggest that the secondary trend had turned down. The minor trend is obscure but appears more bearish than bullish.

A few Letters back I mentioned that many traders will want to "jump in" if Rails better 146.56 on an authoritative increase in volume. A few readers have written to ask what I would do if this occurred. If Rails confirm I may try to "scalp" the market with a few steels and a rail or so -- perhaps Jones & Laughlin, Republic Steel, Norfolk & Western and Southern Pacific. Stop losses would be placed a few points under each purchase.

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Hamilton once wrote, "There is an explanation for every stock market movement somewhere in the future...." At the risk of being accused of drawing conclusions in retrospect, it seems worthwhile to discuss the meaning of the price movements since the bear signal. On March 3, 1960, the Rail Average confirmed the previous penetration of the Industrial Average. In doing so the carriers confirmed the existence of a major bear market. Within a few days of the bear signal the Industrial Average sank to a low of 599.10, but having given the signal for a turn in the tide, both Averages then embarked on an extended and rather complicated secondary (upward) reaction.

It should be remembered that the stock market barometer indicates direction, never extent or duration. Nevertheless, on past precedent the odds now favor a rather severe bear market's developing. The reasoning behind this statement is simple enough. Bear markets by their nature serve to correct the excesses of the preceding bull market. The 1949-59 bull market lasted ten years and advanced the senior Average a total of 525 points. A normal correction of such a period of expansion could easily last three or four years and erase at least half of the preceding 525 point rise.

The meaning of the movements of the market are seldom fully understood at the time. Yet one might well ask, "What was the significance of the secondary reversal which came immediately after the bear signal?" This writer interprets the recent action to read as follows: the market confirmed the fact that the primary trend of stocks and the economy is down. But the rapid secondary recovery suggested that the slide in both stock prices and business would not be immediately disastrous. It is one thing for the "top" to have been seen; it is another for the actual collapse to occur.

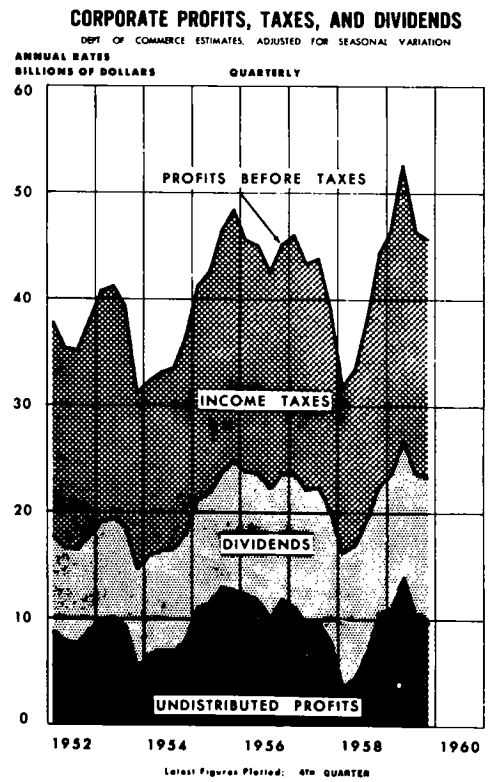
In glancing over my historical charts of the D-J Averages superimposed upon Barron's Business Index, I can pick out many instances where, subsequent to a bull market top, a drastic drop in stock and business indices took place almost immediately. 1929 and 1937 are two outstanding examples. In other cases the slide came many months to over a year after the actual peak in stock prices. For instance, a bull market hit its peak in early 1899, but stocks did not collapse until November of that year and Barron's Business Index did not drop drastically until mid-1900. Another great bull market hit its peak in January, 1906. But stock prices held firm until December, 1906, and business actually improved until mid-1907. Stock prices drifted lower throughout 1907, but business and the market did not collapse until the end of 1907. Again, a bull market hit its high in October, 1916. Stock prices held fairly steady until June, 1917, while business actually improved until mid-1917. Towards the latter part of 1917 business and stock prices plummetted together.

In the present situation Barron's Business Index touched a peak of 106.7 in January, 1960. Stocks and Barron's Index fell almost simultaneously during the first quarter of 1960, but

the market reacted upward in March while Barron's Index continued to fall to last week's low of 85.4 (which was below the lowest figure recorded during the steel strike).

The accompanying chart published by the Federal Reserve Board perhaps best illustrates what has been happening. Here we see corporate profits, undistributed profits and dividends recording a high in early 1959. Since then there has been a steady erosion in all three catagories, and the chart shows that these three indices have fallen below the levels established in 1955.

Dividends and profits are both time-honored measurements of values. The stock market, by giving a bear signal, has said that values have seen their bull market highs and are now heading down. How fast they will descend and how far they will go only time will tell. But if Dow's Theory still holds true, we can expect to see an extended period in which values, as measured by dividends and profits, are on the downgrade.



THE POLLS During February of this year a great stir was set off by the University of Michigan's consumer poll. At that time it was demonstrated that the American consumer was not only optimistic, but he was going to be a definite force behind an expanding economy. Last week we read about the latest University of Michigan poll. Now it seems that the consumer is decidedly less optimistic, and his plans for stimulating the economy have been shelved.

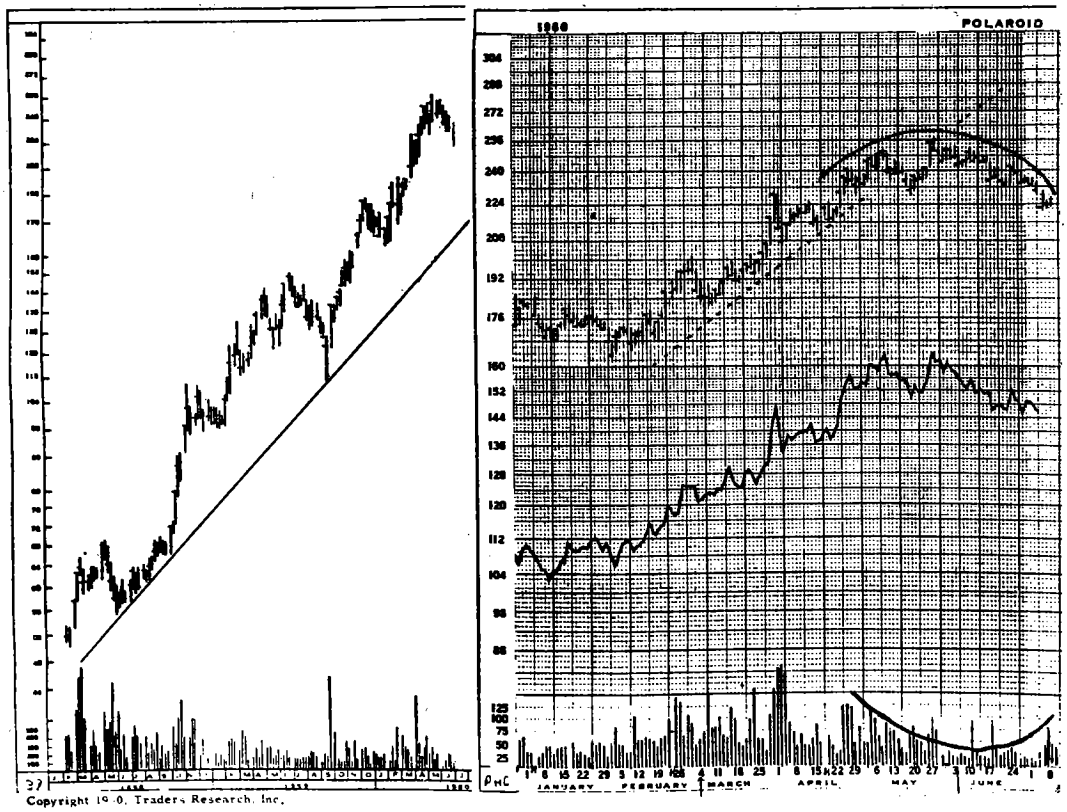
It was most amusing to see the way in which three leading newspapers headlined the story. The hard-hitting Wall Street Journal said, "Consumers Scale Down Buying Plans, 16% Think Recession is Near, Study Finds." The sedate New York Times wrote, "Consumer Cheer Shows a Decline". Harvey Runner, the New York Herald Tribune's leading optimist headlined the story, "Buying Plans of Consumer Stay Bright Despite Drop in Optimism".

A Favorite pastime in this country seems to be the polling of public opinion. Unfortunately, these polls tend to provide an "odd-lot opinion", and for this reason they are usually less than useless. Commenting on the latest University of Michigan poll, the Wall Street Journal noted that despite vanishing optimism, "... there are some bright spots. For one, many people believe our economy is 'depression proof'". But as far as this writer is concerned the public's disbelief in the possibility of a depression is hardly a "bright spot"; on the contrary it seems rather ominous.

I suggest that readers study the logic behind the following paragraph from Garfield A. Drew's book, "New Methods for Profits in the Stock Market": "... A well-nigh universal disbelief that any important trend is possible is a prerequisite of the condition immediately preceding it, since otherwise prices would already be moving rapidly in that direction as action was taken in anticipation of the event".

CHARTS. It is probable that more amateurs are now trading on the basis of individual stock charts than ever before in market history. Many of these "traders" are operating with little or no knowledge of the broad trend of the market, a procedure which can prove rather expensive. In regard to charts and charting, I offer the following personal observations:

(1) Those who expect least from charts usually benefit most.
(2) A "good chart" in a poor industry group has one strike against it; if the market is also in a primary bear trend the chart has two strikes against it.
(3) Charts are least reliable in the final stages of a bull market and early stages of a bear market. At those times the public is "in with both feet", and manipulation, rumor-buying and erratic stock movements are almost the rule rather than the exception.



The accompanying chart (courtesy of Traders Research Inc., 375 Arcade Building, St. Louis 1, Mo.) maps the progress of one of the most glamorous of the "glamor stocks", Polaroid. On the left side of the chart we see the weekly price movements of PRD as it holds spectacularly above a major trend-line which extends from early 1958 to the present. The right side of the chart shows the daily price movements for 1960 (heavy black line is the stock's relative strength against the market).

Beginning in April, 1960, PRD commenced forming a "rounding top". This structure is indicative of a grim struggle between buyers and sellers with sellers eventually (although perhaps only temporarily) winning the battle. Note that the rounding top also violated a secondary upward trendline (dotted line), a further sign of weakness. Volume diminished as the formation reached its upper extremities, which suggested that buying power was waning. This is a normal occurrence in rounding tops. The rounding formation together with last month's 33% drop in RPD's short position suggests that (1) PRD is in for a retesting of its major trend-line or (2) PRD is in the process of topping out of the bull market.

Rounding tops usually appear in high-priced top-grade investment stocks or preferred stocks. It is unusual to see this type of formation in a volatile issue such as PRD.

STOCKS. The following stocks (all in the D-J Industrial Average) are holding above secondary support. A close at the price given in parentheses would mean they were in a position for shorting at the market. Chrysler (43), Goodyear (35), International Harvester (41), Union Carbide (126).

(Written Tuesday July 12, 1960, 1 P.M.)

Thirty Stocks Used in Dow Jones Industrial Averages are:		
Allied Chemical	General Electric	Sears Roebuck
Aluminum Co.	General Foods	Std Oil of Cal.
Amer Can	General Motors	St. Oil of N. J.
Amer Tel & Tel	Goodyear	Swift & Co.
Am Tobacco	Inter Harvester	Texaco Inc.
Anaconda Co.	Inter Nickel	Union Carbide
Bethlehem Steel	Inter Paper	United Aircraft
Chrysler	Johns Manville	U. S. Steel
Du Pont	Owens-Ill. Glass	Westinghouse El
Eastman Kodak	Procter & Gamble	Woolworth
Twenty Railroad Stocks Used are:		
Atchison	Erie	NY NH & H
Atl Coast Line	Great North Ry	Norfolk & West'n
Baltimore & Ohio	Illinois Central	Pennsylvania
Canadian Pacific	Kansas City So	Southern Pacific
Ches & Ohio	Louisv & Nash	Southern Railway
Chi Rk Is & Pac	N. Y. Central	Union Pacific
Del & Hudson	N. Y. C. & St. L.	